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ACTION EUR-08

INFO OCT-01 SS-14 ISO-00 EURE-00 NSC-05 NSCE-00 SSO-00

EB-03 TRSE-00 SP-02 L-01 INR-05 INRE-00 CIAE-00 PRS-01

OMB-01 FRB-01 USIE-00 ABF-01 SIL-01 /044 W
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INFO AMEMBASSY BONN
USMISSION EC BRUSSELS
AMEMBASSY LONDON
AMEMBASSY PARIS
USMISSION OECD PARIS

C O N F I D E N T I A L ROME 1782

LIMDIS

PASS TREASURY AND FRB

EO 11652: GDS
TAGS: EFIN, IT
SUBJ: OSSOLA COMMENTS ON ITALIAN FINANCIAL AND ECONOMIC SITUATION

REF: ROME 1742

SUMMARY. TREASATT SAW BANK OF ITALY DIRECTOR GENERAL OSSOLA FEBRUARY 3 TO SOLICIT HIS VIEWS ON LIRA CRISIS AND PROSPECTS FOR ADOPTION OF EMERGENCY ECONOMIC PROGRAM, FOLLOWING PARTICULARLY SHARP DROP OF LIRA IN EXCHANGE MARKET ON FEBRUARY 2. TENOR OF TALK DID NOT SUGGEST THAT BANK OF ITALY OFFICIALS WERE PANICKING AS RESULT OF CONTINUED DEPRECIATION OF LIRA. HOWEVER, ACCORDING TO OSSOLA, PROSPECTS FOR AGREEMENT ON EMERGENCY ECONOMIC MEASURES (REFTEL) TO DEAL WITH LABOR COST AND CASH BUDGET PROBLEMS REMAIN HIGHLY UNCERTAIN, EVEN THOUGH ITALIAN
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POLITICIANS HAVE BEEN FRIGHTENED BY CURRENT LIRA CRISIS

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INTO TAKING THESE PROBLEMS MORE SERIOUSLY. END SUMMARY.

1. LABOR COSTS AND BUDGET DEFICITS. DR. OSSOLA WAS MORE HARRIED THAN USUAL DURING MEETING. THIS WAS PARTLY RESULT OF ITALIAN PRESS COMMENTS ON FEBRUARY 3 (BOTH FAVORABLE AND CRITICAL) CONCERNING TALK WHICH HE HAD GIVEN ON FEBRRUARY 2 STRESSING NEED TO DEAL WITH LABOR COST AND BUDGET DEFICIT PROBLEMS. IN HIS SPEECH (GIVEN AT OPENING OF YEARLY TRAINING COURSE FOR BANKERS), OSSOLA HAD REPORTED THAT IN PERIOD 1973-75 UNIT LABOR COSTS HAD INCREASED BY 37 PERCENT IN ITALY AGAINST INCREASE OF ONLY 16 PERCENT IN COMPETING COUNTRIES. IN SAME PERIOD AVERAGE ANNUAL INCREASE IN REAL WORKER EARNINGS IN MANUFACTURING INDUSTRY HAD BEEN 9.5 PERCENT IN ITALY COMPARED TO RENGE OF MAXIMUM 6.6 PERCENT (IN JAPAN) AND MINIMUM OF 0.9 PERCENT (IN UNITED STATES) OF THE MAJOR INDURSTRIAL COUNTRIES. ALSO, EVEN DURING SECOND HALF 1975, WHEN ITALIAN RATE OF INFLATION HAD BEEN CONSIDERABLY REDUCED, IT WAS STILL DOUBLE THE AVERAGE FOR INDURSTIAL COUNTIES AS A GROUP, TRIPLE THAT OF UNITED STATES AND FOUR TIMES THAT OF GERMANY AND JAPAN. AND IN 1975 THE CASH BUDGET DEFICIT REACHED ABOUT 14 PERCENT OF NATIONAL INCOME. OSSOLA HAD POINTED OUT THAT WIDESPREAD USE OF COST OF LIVING INDEXING OF WAGES LIMITED THE BALANCE OF PAYMENTS ADJUSTMENT EFFECT OF A LIRA DEPRECIATION. THIS WAS BECAUSE OF INFLATIONARY FEEDBACK THROUGH HIGHER IMPORT COSTS, CONSEQUENT RISE IN COST OF LIVING AND AUTOMATIC WAGE INCREASES THROUGH ESCALATOR CLAUSES. USE OF MONETARY POLICY BY BOI COULD NOT CONTRIBUTE MUCH TO REMOVAL OF REAL CAUSES OF CRISIS. IF MEASURES WERE NOT TAKEN TO DEAL WITH DISEQUILIBRIA BETWEEN LEVELS OF LABOR PRODUCTIVITY AND LEVELS OF LABOR INCOM, OSSOLA SAID, RESULT WOULD BE INCREASE IN UNEMPLOYMENT, DETERIORATION OF PRODUCTIVE SYSTEM AND ITALY'S PROGRESSIVE EXCLUSION FROM EC.

2. EXCHANGE MARKET DEVELOPMENTS. DESPTITE CONTINUED UNSETTLED EXCHANGE MARKET CONDITIONS, ESPECIALLY ON FEBRUARY 2, OSSOLA DID NOT INDICATE THAT BANK OR GOVERNMENT WAS CONTEMPLATING ANY TRADE OR EXCHANGE CONFIDENTIAL

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CONTROL RESTRICTIONS. (IN HIS SPEECH HE HAD AGAIN STRESSED FACT THAT ITALY HAS INTERNATIONAL COMMITMENTS AGAINST TAKING SUCH MEASURES.) OSSOLA SAID THAT, IN FACE OF CONTINUED DECLINE OF LIRA IN EXCHANGE MARKET, GOI POLITICIANS STILL TEND TO HOPE THAT SOMEHOW BANK OF ITALY CAN CALM MARKET THROUGH INTERVENTION. HOWEVER, BOI OFFICIALS HAVE EXPLAINED THAT BANK DOES NOT HAVE SUFFICIENT FOREIGN RESERVES NOR PROSPECTS OF

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OBTAINING SUFFICIENT FOREIGN CREDIT TO RESUME INTERVENTION ON SIGNIFICANT SCALE. FURTHERMORE, BANK OFFICIALS DO NOT WANT TO INCUR LARGE INCREASE IN FOREIGN DEBT, SINCE PROCEEDS WOULD LIKELY BE WASTED IN INEFFECTIVE MARKET INTERVENTION. WHEN ASKED WHAT GOI COULD DO ABOUT LIRA CRISIS, OSSOLA HAD TOLD MINISTER COLOMBO THAT STRICT COMPLIANCE BY ITALY WITH COMMITMENTS TO INTERNATIONAL AGENCIES RE DOMESTIC CREDIT EXPANSION, AMOUNT AND METHOD OF FINANCING OF TREASURY CASH DEFICIT AND RATE OF INCREASE IN BUDGET EXPENDITURES WOULD MAKE IMPORTANT CONTRIBUTION TO DEALING WITH FINANCIAL CRISIS. DURING MEETING WITH PRIME MINISTER AND OTHER HIGH GOVERNMENT AND BANK OFFICIALS LATE ON FEBRUARY 2, OSSOLA SAID THAT HE HAD REFUSED TO DISCUSS PROPOSED INDUSTRIAL RECONVERSION PLAN, SINCE IT MADE NO SENSE TO HIM AT PRESENT TIME AND IN PRRESENT CIRCUMSTANCES TO TALK ABOUT LARGE NEW EXPENDITURE PROGRAM.

3. POLITICS BEHIND ECONOMIC POLICIES. OSSOLA SAID THAT ITALIAN POLITICIANS HAVE BEEN "TRAUMATIZED" BY LIRA CRISIS INTO BEING SOMEWHAT MORE OPEN-MINDED ABOUT ADDRESSING DIFFICULT POLITICAL/ECONOMIC PROBLEMS. HOWEVER, THERE WAS STILL GREAT UNCERTAINTY AND DISARRAY IN POLITICAL CIRCLES AS TO PROPER METHOD FOR DEALING WITH LIRA CRISIS. HE THOUGHT THAT INCREASED PRESSURE (UNSPECIFIED BY OSSOLA) ON THESE POLITICIANS WAS DESIRABLE IN ORDER TO FORCE THEM TO MAKE SOME DIFFICULT ECONOMIC POLICY DECISIONS. HE ACKNOWLEDGED THAT DURING CURRENT IMF STANDBY NEGOTIATIONS FUND IS PRESSING GOI TO TAKE SOME ACTION TO DEAL WITH LABOR COST AND CASH BUDGET PROBLEMS BUT THAT IMF IS TOO REMOTE FOR ITS PRESSURES TO BE MORE THAN MARGINALLY USEFUL. EVEN BOI
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USE OF MONETARY POLICY TOOLS HAS BECOME MORE DIFFICULT THAN IN PAST. THSIS IS BECAUSE MOST MONETARY MEASURES, E.G., CHANGE IN RESERVE REQUIREMENTS, DISCOUNT RATE CHANGES AND EXCHANGE CONTROL MEASURES, REQUIRE FORMAL ACTION AT POLITICAL LEVEL. IN PAST, BOI WAS ABLE TO RECOMMEND AND OBTAIN RELATIVELY EASY APPROVAL FOR SUCH MEASURES. IN CONTRAST, DURING PRESENT GOVERNMENT CRISIS EVEN MINSTERS, THEMSELVES, ARE UNWILLING TO TAKE DECISIONS AND WANT TO REFER EVERYTHING TO PRIME MINISTER'S OFFICE. VOLPE

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Message Attributes

Automatic Decaptioning: Z
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: FINANCIAL CRISIS, DIPLOMATIC DISCUSSIONS
Control Number: n/a
Copy: SINGLE
Draft Date: 03 FEB 1976
Decaption Date: 28 MAY 2004
Decaption Note: 25 YEAR REVIEW
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: ShawDG
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976ROME01782
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Film Number: D760040-0945
From: ROME
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19760287/aaaacyuk.tel
Line Count: 164
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EUR
Original Classification: CONFIDENTIAL
Original Handling Restrictions: LIMDIS
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 3
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: LIMDIS
Reference: 76 ROME 1742
Review Action: RELEASED, APPROVED
Review Authority: ShawDG
Review Comment: n/a
Review Content Flags:
Review Date: 24 MAR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <24 MAR 2004 by ElyME>; APPROVED <03 AUG 2004 by ShawDG>
Review Markings:

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04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: OSSOLA COMMENTS ON ITALIAN FINANCIAL AND ECONOMIC SITUATION
TAGS: EFIN, IT, (OSSOLA)
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006